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E.O. 12958: DECL: 06/01/2016
TAGS: EFIN ECON PGOV SOCI HO
SUBJECT: HONDURAS: IMF INCREASINGLY CONCERNED ABOUT TREND
OF GOH FISCAL POLICIES

Classified By: ECONOMIC CHIEF PATRICK DUNN FOR REASONS 1.4 (B) AND (D)

¶1. (C) Summary: The International Monetary Fund is increasingly concerned about the direction of GOH fiscal policies. Rising losses in parastatal telecommunications and energy companies, coupled with the possibility of a return to unsustainable wage hikes for teachers, threaten to shatter GOH compliance with its Fund commitments. It is not too late for the GOH to turn the situation around, but that will require political leadership and some tough decisions on the part of President Zelaya. The Fund appears prepared to deliver a sharp message to Zelaya in a June 4 meeting in Washington. Post concurs that, absent a course correction, the medium term situation could become bleak, and therefore supports any Fund attempt to advise Zelaya in plain terms just how dangerous his continuing fiscal policy improvisation could be. End Summary.

¶2. (C) The International Monetary Fund (IMF) has failed to reach agreement with the GOH on the results of its semi-annual review of GOH performance. In IMF parlance, "discussions are continuing," as an IMF May 2-10 review and subsequent follow-up contacts have failed to reassure the Fund. Resident Representative Hunter Monroe met with EconChief and AIDOff on May 31 to discuss what the Fund is concerned could become a rapidly deteriorating situation.

Spending is Controlled... In Fact, Too Controlled

¶3. (C) According to Monroe, the Fund is "more concerned now than when the mission left" on May 10. Monroe highlighted the three areas of energy, telecommunications, and public sector wages as the most troubling. Moreover, the Zelaya Administration is "under-executing" its investment and poverty alleviation programs. In actuality, the GOH missed the floor (minimum expenditure) requirement for poverty alleviation spending in the first quarter. This figure is only indicative (the figures that count will be released in June), but the trend is giving both the Fund and other donors pause. Thus, while overall deficit figures remain well within established targets -- the GOH actually ran a fiscal surplus in the first quarter -- those laudable bottom-line results mask a disturbing failure to disburse capital investment, and an equally worrisome focus on expensive, consumption-oriented spending that, if left unchecked, could

eventually drive the program off the rails.

Telecomms: Failure to Carry Out the Plan

¶4. (C) The GOH and the Fund have long recognized that rate restructuring at the parastatal telephone company Hondutel would be vital to balancing the GOH's books following Hondutel's loss of its monopoly on December 25, 2005. Predictably, shortly after Hondutel lost that monopoly, rates for international calls fell from over USD 0.90 to about USD 0.38 per minute to the U.S. The monopoly rents Hondutel enjoyed for decades had allowed it to cross-subsidize low-cost local calling, maintain a highly paid and bloated workforce of 3,000 employees, and return an estimated 9 billion lempiras (about USD 500 million) to the GOH government coffers over the last four years. Snuggly protected and monstrously inefficient, Hondutel has long been a cash-cow for the GOH.

¶5. (C) Consequently, the Fund and the GOH agreed on a "prior action" for program implementation, consisting of five reforms to address the lost Hondutel revenues. (Note: Hondutel will likely continue to be a profit center, but revenues are expected to drop significantly. End Note.) Those reforms, detailed in the third IMF review document (available on the IMF website) include such actions as increasing basic line charges, increasing user charges, and capturing "grey traffic." To date the GOH has not taken these steps. According to Monroe, "there is no going back" on these agreements, despite any political difficulty this might now pose for the GOH. Failure to implement meaningful reforms would not only violate the accord with the Fund, it would also perpetuate the fiscal imbalance accruing on the

GOH's books.

Energy: Failure to Have a Plan

¶6. (C) The second Fund concern stems from the parastatal electricity company, ENEE, which continues to lose approximately 300 million lempiras (about USD 15 million) per month. According to experts, fixing ENEE involves five steps: replacing old equipment and reducing technical losses; installing meters on the estimated 20 percent of customers (or about 200,000 homes) that are currently neither metered nor billed; renegotiating generation contracts with electricity providers to lower costs; replacing political sinecures at ENEE with technically proficient administrators, and raising electricity rates. One expert indicated that the first four combined could reduce losses by 100 million lempiras per month -- only one third of what is required. In short, there is no obvious alternative to raising electricity rates.

¶7. (C) Electricity rates have not kept pace with generating costs, and raising the base rate has proven so politically distasteful that the GOH adopted a "fuel surcharge" instead. Even with the fuel surcharge, rates fail to cover costs. When former ENEE Director Juan Bendeck attempted to raise the surcharge from 55 percent of the base electricity bill to 59.5 percent, President Zelaya replaced him. New director Leo Starkman warned early-on of the need to raise rates when he assumed Bendeck's position, and was reportedly similarly ordered by Zelaya not to raise rates. In June 2006, ENEE will actually reduce that surcharge to 53 percent, further exacerbating monthly financial losses. With annual losses projected at more than USD 120 million, or over 1.5 percent of GDP, a continued hemorrhage of funds from ENEE imperils not only the company itself, but potentially the overall GOH fiscal deficit targets as well.

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Teachers Wages: A Time Bomb, Ticking Down To February 2007
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¶8. (C) The third and by far most dangerous concern is that of teachers' wages and benefits. In the late 1990s, then-president of Congress Rafael Pineda Ponce engineered a wage and benefit increase policy for teachers that far exceeded pay raise rates elsewhere in the economy. Unable to meet the costs, the GOH has reportedly never fully complied with these "estatutos." Despite that, the total GOH public sector wage bill exploded, nearly doubling over that period from 6 percent to 11 percent of GDP. Recognizing that such growth was unsustainable, the GOH agreed to the IMF demand that the benefits be folded back into the overall government wage structure, thereby controlling public sector wage growth. The GOH committed -- in a 2003 wage agreement -- to design the wage reform program by 2005, and to implement it by February 2007. (Note: The Maduro Administration essentially kicked the can of the teachers, problem down the road by ensuring that real reform was not due until after they left office. End Note.) Citing the November 2005 Presidential elections, the GOH sought and received a waiver of this performance criterion, getting a passing mark from the Fund, but with the explicit understanding that the wage issue must still be resolved by 2007 as agreed.

¶9. (C) Zelaya has since promised the teachers full implementation of the estatutos, and has appointed Pineda Ponce as his Minister of Education. Pineda Ponce further exacerbated tensions by calling in January 2006 for fully funding the benefits out of debt-relief savings. In May 2006, he emerged from a meeting with Zelaya and the teachers, unions and announced that the 2003 wage law would be abrogated, and the estatutos fully funded. If carried out, such an action would be a "significant reversal" of progress under the Fund agreement, according to Monroe. The cost of such an action is difficult to quantify, but estimates range up to 7 billion lempiras (about USD 368 million), equivalent to over 5 percent of GDP. That kind of an unbudgeted spending commitment could, in a single blow, knock the GOH entirely out of compliance with its Fund commitments.

What Went Wrong?

¶10. (C) Comment: A few short weeks ago analysts were describing GOH compliance using terms like "outperforming its targets." What happened? Essentially, two things: First, the GOH continues to announce expensive programs like subsidies to farmers, agricultural sector bailouts (which would also be a disincentive to future lending to the sector), and fuel price subsidies, while failing to deal with unsustainable big-ticket items including electricity and public sector wages. If the current rhetoric betrays a genuine lack of political will to confront these issues, the GOH/Fund program is heading for serious trouble. However, that is not a forgone conclusion by any means, which leads us to the second factor. Sensing that the GOH is beginning to head in the wrong direction, the Fund apparently seeks to deliver a strong message to the GOH during Zelaya's June 4 meeting with IMF Western Hemisphere Department Chief Anoop Singh. He will reportedly warn Zelaya of the dire consequences of failing to come to grips with a rapidly deteriorating situation. It would appear that the Fund feels an early, sharp intervention now could prevent the medium-term collapse of the program in Honduras.

¶11. (C) Comment continued: Post concurs with the Fund's concerns, and with delivering a strong message to Zelaya about the need to exercise political leadership and maintain fiscal discipline, particularly this early in his four-year

term. In the last year, Honduras has joined CAFTA, qualified for MCC, earned USD 2.8 billion in debt relief, established solid macro foundations, and (for the first time in decades) sustained four years in a row of GDP growth. This historic constellation of positive economic news might never recur. Simply put, this is Honduras' best ever hope for setting itself on a path towards sustainable economic growth and poverty alleviation. Neither we nor Honduras can afford to let the Zelaya Administration squander that. End Comment.

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